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GLOBAL MARKET COMMENT: EMERGING MARKETS 2002 ROUNDUP: DRIVERS AND LANDMINES

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Emerging Markets 2002 Roundup: Drivers and Landmines

Emerging markets equities walloped developed markets equities for the year through November, with MSCI Emerging Markets Free (EMF) returning -2.6%, compared with -18.9% for MSCI World and -20.3% for MSCI EAFE. Emerging equities started the year out strong, with a first quarter return of 12.0%, but as the year progressed they gave back all gains and more. (All returns represent total returns in local currencies for the year through November unless otherwise noted.)

While equities in emerging markets outperformed those in developed markets, the enormous disparity of returns across regions and countries allowed investors to significantly out- or underperform the benchmark by making tactical bets. Currency was the key call, but investors had to make the right regional or country bets as well. For example, MSCI Latin America returned -0.2% for hedged investors, while its return was -24.1% for unhedged, US$-based investors. Argentina and Brazil, where the *peso* plunged 72.5% and the *real* 36.7%, were two prominent examples where failure to hedge currency exposure would have been catastrophic. MSCI Argentina returned 56.4% in local currency and -56.9% in US$, and MSCI Brazil returned 0.1%, and -36.6%, respectively. However, other emerging markets currencies *appreciated* sharply against the US$ for the 11 months ended in November, resulting in unhedged US$ returns of 21.0% in South Africa, 26.2% in Hungary, and 46.4% in the Czech Republic, compared to local currency returns of -6.5%, 9.8%, and 27.5%, respectively. The combination of significant currency appreciation and depreciation in various countries amounted to a very small difference between US$ and local currency returns at the aggregate index level (MSCI EMF returned -2.8% for US$-based investors).

Performance was also somewhat disparate across emerging markets sectors; however, most sectors within MSCI EMF posted returns in the black for the year-to-date. With the exception of materials, the largest sectors reported negative returns. Financials, which accounts for 17.5% of MSCI EMF's market cap, returned -6.6%, information technology, with a 19.6% weight, -12.3%, and telecom, with a 12.9% weight, -12.3%. Materials, with a 16.7% weight, was the primary exception to this pattern, as it returned 8.0%. Other sectors that performed well were consumer discretionary, 14.8%; energy, 13.8%; and health care, 18.2%.

Economic fundamentals for most emerging regions appear healthy, especially relative to developed economies. Despite the global slowdown, regional emerging economies are expected to outperform the United States and Europe in 2002. According to JPMorgan, for 2002 Asia's economy will grow 5.4%, emerging Europe's, 3.9%, and South Africa's, 3.0%, while Latin America's economy is expected to *shrink* 1.5%. Historically, emerging economies generally have not performed well under global conditions of financial instability and high levels of risk aversion, but most of them have been strengthened by the adoption of floating exchange rates and the improvement in balance of payments in recent years.

Latin America - Disparities Expand

Despite its worst economic slump in 20 years, Latin American equities were the best-performing of all emerging markets subregions—for hedged investors. In local currency, EMF Latin America returned -0.2%, while US$-based investors endured a -24.1% return. In local currency terms, the best performers were MSCI Argentina, which returned 56.4%, Venezuela, 54.1%, and Colombia, 50.6%, while the best performers in US$ were Columbia, 23.1%, Peru, 21.4%, and Mexico, -9.6%.

The region is exhibiting a growing disparity between the four countries experiencing economic growth—Mexico, Chile, Colombia, and Peru—and the three that are mired in severe recession—Argentina, Brazil, and Venezuela. According to JPMorgan, the real GDP of the four growth countries will expand 1.6% in 2002 and 3.3% in 2003, compared with the recession economies that are expected to *contract* 3.4% and 1.7%, respectively. Over recent years, the four growth countries have reduced their dependence on capital inflows, strengthened their trade links, and carried through with economic reforms. However, in the three recessionary countries, inflation appears imminent, government budgets are stretched, and economies remain overly dependent on foreign direct investment. In addition, popular sentiment throughout the region, especially in the three slow growers, seems to be shifting away from market-oriented economic reforms and toward a larger role for the government.

South Africa - The Wedge between Hedged and Unhedged

MSCI South Africa returned -6.5% for hedged investors and 21.0% for those who were unhedged. South Africa has thus far weathered the global economic slowdown and domestic monetary tightening fairly well, and its real GDP is forecast to grow 3.0% in 2002 and 2.9% in 2003, according to JPMorgan. The rand's 29.4% appreciation against the US$ year-to-date has not yet slowed exports, but further appreciation could have an impact. Inflation is estimated to climb 12.6% through the year ending in November.

Europe, Middle East, and Africa - Domestic Demand on the Rise

Emerging Europe is benefiting from rising domestic demand, especially private consumption and public spending. Despite meager growth in the eurozone for 2002 (1.0% to 1.5%), emerging Europe's economy is expected to grow 3.9% in 2002 and 3.5% in 2003, according to JPMorgan. Making the correct country bets was more important than currency hedging decisions, though the Czech *koruna* and Hungarian *forint* appreciated about 15% against the US$. For the year-to-date, the MSCI Europe Middle East and Africa Index returned -1.9% in local currency and -1.1% in US$. The best-performing market was the Czech Republic, with a 27.5% return, while the worst-performing markets were Morocco and Israel with returns of -18.8% and -18.9%, respectively.

Emerging Asia - The Global Cycle and Domestic Demand

In emerging Asia, the disparity of performance across countries was significant. With MSCI Asia returning -2.0% in local currency and 1.6% for US$-based investors, currency played a role in driving returns, but much less so than in Latin America. Asia's performance was powered by Pakistan's outsized 94.9% return and Thailand's 26.5% return. Philippines Free and Taiwan weighed on the index, with returns of -22.5% and -20.0%.

Although the region's real GDP growth slipped in the second half of 2002, it is still outperforming the rest of world. Emerging Asia's GDP is forecast to grow 4.5% in the second half, compared with 7.0% in first half, according to JPMorgan. In 2002 China is expected to lead the region in economic expansion, with 8.0% growth, powered by solid domestic demand and extremely strong export growth, Korea is expected to post a 6.0% gain, while Hong Kong and Singapore are expected to grow only 2.2% and 2.3%, respectively. In 2002, the main driver of exports was intra-regional trade growth, which accounts for about 40% of the region's total exports. Of course, export growth ultimately depends on demand from outside the region, with about 50% of the region's GDP earned from the exports of goods and services, compared to an average of 27% for all developing nations, and 17% for Latin America.

Investment Implications—A Look Into 2003

On a relative and absolute basis, emerging markets equities are inexpensive. Despite attractive valuations, however, 2002 has been a fairly typical year for emerging markets—extreme volatility in equity returns and currency movements, as well as wide disparities in regional and country performances. Even if emerging economies pick up in 2003, as analysts generally believe, unexpected events will continue to roil this asset class, while markets that manage to avoid blowups may enjoy significant upside movement. While the risk/reward ratio of emerging equities is favorable, only investors who can tolerate their inherent volatility should consider making commitments. Given that emerging markets equities are vulnerable to changing investor sentiment and represent a high-beta play on global growth, emerging equities as a whole could again outperform developed equities in 2003 if the world economy begins to gain steam. The real surprise will be if the global economy does *not* pick up and they still manage to outperform developed equities.